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THE YEAR IN BUSINESS
COUPS & CATASTROPHES

FORD'S COMEBACK



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Donald Petersen*

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HOW THE TAX
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CONTROL DATA:
DOES IT HAVE
A FUTURE?

THIRD WORLD DEBT:
WHY BAKER'S
PLAN WON'T WORK

FORTUNE

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WHY BAKER'S DEBT PLAN WON'T WORK

Treasury Secretary Baker is asking banks to increase lending to Third World countries. He ignores the awful truth: the countries already owe too much. The only logical solution—a painful one—is for the banks to own up to some big losses on their loans. ■ *by Carol J. Loomis*



THOUGH widely hailed as bold and innovative, Treasury Secretary James A. Baker's plan for solving the Third World debt problem won't work. Like the plan in

place up to now, this one doesn't face up to the deep-down truth about the debt problem: the debt is too big for the debtors to handle on a sustained basis. Their burden must be lightened. That can happen only if the banks holding the countries' debt agree to take less from the debtors than they're now demanding. Taking less will mean write-downs of the banks' loans—the excruciating step the banks have been avoiding for years.

In private some bankers concede the countries can't live with their debt. In public many are busy lining up behind Baker's plan, which would throw more money at the problem—granting the countries new loans to pay the interest on their old, and therefore getting both debtors and creditors in deeper. By fuzzing up the essentials of this problem and encouraging optimism where none seems warranted, the plan may also postpone a reckoning. But that will simply increase the amount of pain that will eventually have to be distributed.

In dollars, the problem is bigger than it was three years ago, when Mexico, Brazil, and a slew of other Third World countries fell into desperate trouble on their foreign debt and inspired Plan 1. The countries, their creditor banks, and the International Monetary Fund swung into emergency case-by-case action aimed at getting everybody through what many labeled a "temporary liquidity problem." The strategy required that new money be lent the countries in return

for their making economic "adjustments." They did so—buckling down to harsh austerity programs and achieving trade surpluses, which provided hard currencies for debt service. By now this plan was to have restored many of the countries to creditworthiness. It has not.

Worse yet from their creditors' standpoint, some countries have become newly defiant about their debt. They are up in arms about the austerity that has been their lot and ominous in warning that the hardships threaten their democracies.

The fragility of the situation brought in Baker with a plan aimed at easing the unrest, keeping the countries in line on their debt, and edging them once again and evermore toward creditworthiness. The plan takes in 15 debtors, roughly describable as middle-income countries deeply in hock to the banks and pariahs in the credit markets. The 15 owe a blockbuster \$437 billion, carrying interest of around 10%. Baker's plan calls for adding \$40 billion to the debt over the next three years, half to come from banks, half from official creditors such as the World Bank. But this money is to be lent only if the countries make "structural changes" that are supposed to invigorate their economies, in theory enabling them to grow their way out of the debt problem.

The impediments to this plan are many (see box), and it may never fly. It shouldn't. Baker is right about countries needing to grow. But they can't while devoting so much of their resources to servicing debt—not now, still less with Baker's billions. By focusing on 15 countries with measurable economics, Baker's plan illuminates the mathematical and political impossibility of staying the course we're on.

The 15 countries overdosed on borrowed

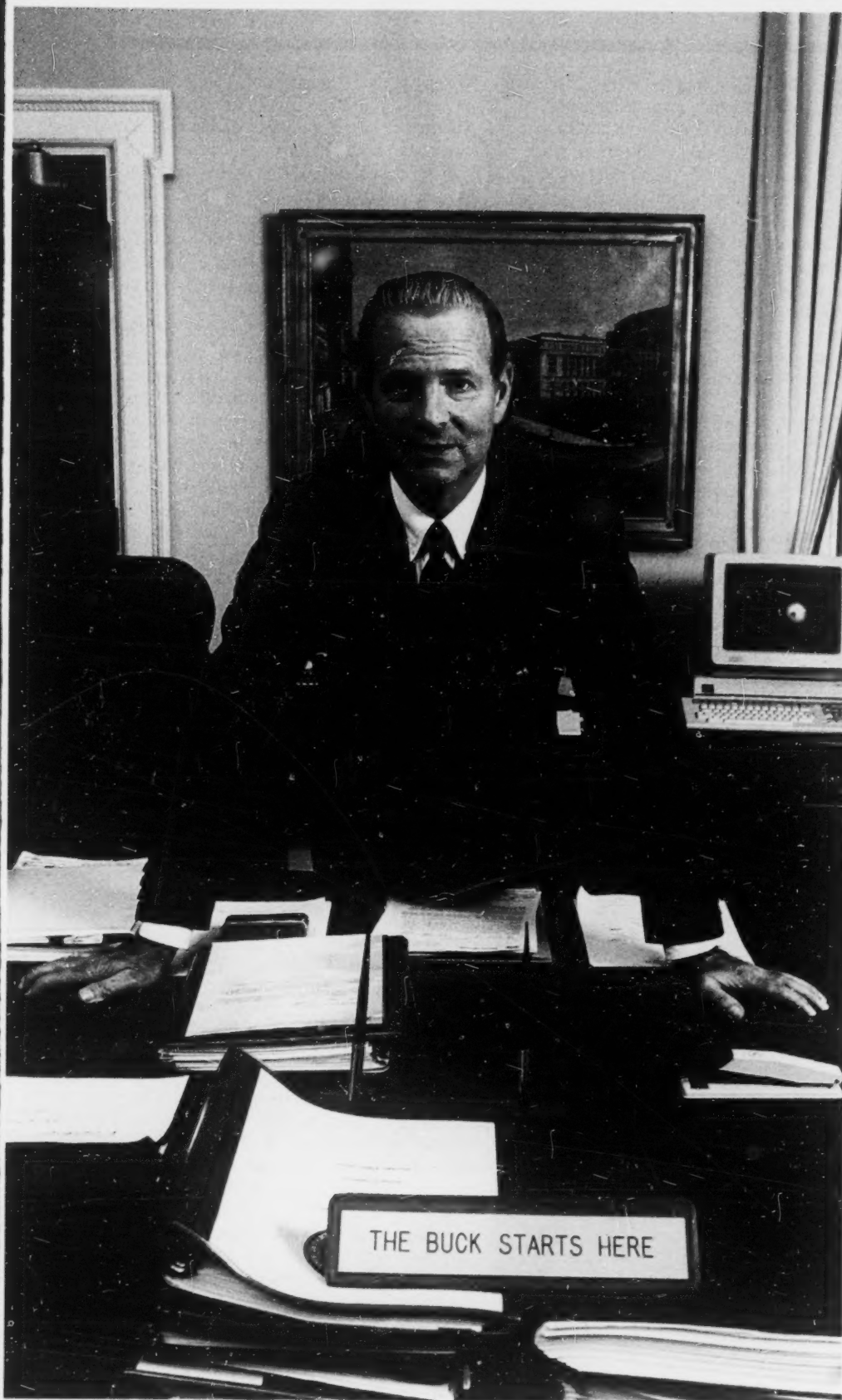
funds in the 1970s and early 1980s. The greater fools were the banks who let them do it. "Large borrowers," an expert once warned, "are apt to control the bank; and when this is the relation between a bank and its customers, it is not difficult to decide which in the end will suffer." The expert: Hugh McCulloch, first U.S. Comptroller of the Currency, who delivered this warning in a letter to national banks in 1863.

McCulloch also urged that loans be well secured and short in term. He surely could not have imagined that banks would become trapped in loans of extended maturity, made to sovereign borrowers which the banks could not force to pay. In the sweep of history, commercial banks were not until recently major suppliers of capital to less developed countries. They left that risk to others to whom it was more suitable. Among these were bondholders who went down the tubes when various Latin American governments defaulted on foreign debt a half-century ago.

Unmindful, banks leaped into the Third World game in the late 1960s. Their Pied Piper was Citicorp, which had set a goal of increasing earnings 15% every year and saw overseas profits as a golden way to do it. Today, of that \$437 billion owed by the 15 countries (which are, of course, only some of the Third World borrowers), commercial banks worldwide hold \$275 billion. Of that, U.S. banks hold \$94 billion, about 85% of it on the books of the 24 largest banks. The leader, still, is Citicorp, whose Citibank has an estimated \$12 billion of the debt.

The U.S. total of \$94 billion is an enormous threat to the banks. First, the debt produces roughly \$10 billion in interest revenues annually, and the disappearance of all or much of that income would be disastrous for profits. How disastrous is difficult to say be-

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The sign on Baker's desk catches the spirit of his plan to lend more to Third World debtors.

DENNIS BRACK-BACK STAFF

cause the disappearance of the revenue would cut taxes and perhaps also some operating costs. But many banks don't pay much in taxes, and operating costs wouldn't drop automatically because revenues fell. Profits could get hit *hard*. For perspective: total profits of the 100 largest U.S. bank holding companies in 1984 were \$7.8 billion.

Second, if the borrowers cut back interest payments, accounting rules say banks must write down the loans. These charges in turn make their way through the income statement. Their threatened size is so large that they could create huge losses, which would decimate the equity capital of the banks.

Because U.S. banks have sharply increased their capital in recent years, partly out of fear of the debt crisis, this \$94-billion debt bomb has shrunk somewhat in relative importance. The debt is now a mere 110% of the total equity capital of the 100 largest bank holding companies, compared with 140% in 1982. That understates the problem for the money center giants, though. The amount the 15 countries owe Citicorp, for example, is an estimated 180% of Citicorp's equity, compared with an estimated 230% in 1982. The amounts of lending Baker proposes are relatively modest and probably wouldn't keep banks from further lowering their ratios.

TODAY'S PERCENTAGES slightly overstate the size of the threat to banks in two ways. First, banks have already charged their income statements for expected losses on certain foreign loans—though, alas, they have not trod that conservative path very far. Second, if the loan values still on the books were to be wiped out partially or entirely, the charges would be tax deductible—assuming the banks had taxes to pay and current tax laws prevailed (see Politics & Policy). Which gets back to basics: we are talking about a powerful threat. The stock market has acknowledged it. Money center bank stocks have sold at low price-earnings multiples for years. How much further the stocks might sink if the banks owned up to reality and made wholesale write-downs is unknowable.

The factor keeping the threat in check is the interest payments on the debt. If interest stopped coming in from major borrowers such as Brazil and Mexico (which by one means or another have kept paying), bank profits would be blasted, big write-downs would follow, and the fish would be in the soup. These facts rivet the attention of bankers on keeping the interest coming.

These facts also lead to a great charade, involving the gap between the interest the debtors owe and the funds available to pay it (other than from the banks). To fill this gap

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and to preserve the illusion that, yessir, just about everybody's current, the banks have in the past three years stepped up to a program of forced support. As things work, the banks lend money to the countries, which then pay all or part of it back as interest on their giant pre-existing loans—a shuffle the trade calls "round tripping," though they might also call it borrowing from Peter to pay Peter. Naturally the new money lent swells the total debt and therefore the burden the countries must service next time around. Those loans also get the banks in deeper.

In the early, halcyon days of the debt crisis, bankers talked a lot about actual pay-downs of the debt. Nobody does that now. Instead, the drill is repeated restructurings of the debt, which means stretch-outs and rollovers (a banker's term inspiring the quip "a rolling loan gathers no loss"). So many restructurings have occurred that even international bankers can't keep them straight. But they never forget the goal. Says a senior officer of a New York bank, who asked for anonymity, "The interest is the mountain we have to climb, not repayment."

So what are the prospects for climbing the mountain, year after year, generation after generation? The interest bill for the 15 countries is now about \$45 billion annually. The hard currencies needed to meet the bill can be generated by the countries in various ways. The basic do-it-yourself way is to run trade surpluses. The outside-help way is to

get infusions of foreign capital, including those round-tripping loans from banks.

In the old days, trade surpluses for the 15 were rare. When the debt crisis broke in 1982, however, the countries moved into their austerity programs, slashed imports (from luxuries to Caterpillar tractors), and began to deliver surpluses. The countries were stars in 1984, when the combined surpluses of the 15 were \$44 billion, almost enough to cover their combined interest bill. That turn of events reduced the need of some countries for new loans and encouraged optimism about the debt problem.

BUT TIME is showing that these big surpluses cannot be sustained, partly because the austerity programs have begun to crumble. This year trade surpluses are expected to be only \$35 billion or so. Thus we are ending a three-year period in which the countries failed, despite a good hard try and major belt-tightening efforts, to earn the funds they need for interest. Moreover, Baker has implicitly predicted failure for the next three years. His call for \$40 billion in new loans over the period implies the 15 countries are going to come up short by that amount.

Baker appears to view these next three years as preamble, a getting-collected period in which those invigorating economic changes will begin to work their magic. For this period, he is saying, the creditors need

to hang in there, helping out. Thereafter, as he seems to see it, at least some countries will bounce to self-sufficiency, able on their own to cover the interest bill on their debt.

The unlikelihood of that is demonstrated by some big-picture facts showing how heavy the debt burden is for the countries. Economists often compare debt with exports, and some say, as Morgan Guaranty economists did in a 1983 study, that a country courts peril when it lets its foreign debt get as high as twice annual exports. At that level and up, so the thinking goes, debt service consumes too large a portion of export income, leaving too little to finance imports.

Unfortunately, most of Baker's 15 are miles above that sane debt-to-exports level, including such big Latin American debtors as Brazil, Mexico, Argentina, and Chile. Their debt is about four times their estimated 1985 exports. The interest they owe eats up roughly half their export income. To accommodate the interest bill, the countries have put a vicious squeeze on imports, which looks politically unsustainable.

Another view of the mountain to be climbed can be gained by comparing the \$437-billion foreign debt of the 15 countries with their total economic output: the debt is equal to about 58% of their aggregate GNP. In contrast, the \$200-billion foreign debt of the U.S., though worrisome to some economists, amounts to only about 5% of GNP. With so much of their GNP matched by foreign debt, Baker's 15 are naturally applying a lot of their output to interest: an average 7.3% of GNP, an enormous proportion to be shipping out of the country for this purpose. Were the U.S. shipping out an equivalent portion of its GNP, the dollars winging away would be \$280 billion annually.

Fast growth in GNP and exports in the 15 countries, combined with minimum growth in debt and interest, would begin to chip away at the problem. This is the remedy Baker has in mind. But the 15 countries have no history of such combinations and certainly weren't verging on any in the past few years of improvements in trade surpluses. Too much of the gain came from cuts in imports, not growth in exports. Debt-to-exports ratios have actually risen since 1982 and interest-to-exports ratios haven't fallen, despite a helpful decline in dollar interest rates.

Endemic problems block economic progress. Rapid population growth—2½% annually in Mexico and Brazil—drags at growth in per capita GNP and keeps living standards depressed. Flight capital erodes the countries' productive base and capsulizes the ab-



He won't pay: Peru's new president, Alan García Pérez, has made bankers see red.

BAKER'S PLAN HAS A PECK OF PRACTICAL PROBLEMS

■ Treasury Secretary James Baker envisions a three-pronged attack on the problems of 15 debt-laden developing countries. On one front he wants the debtor countries to make structural changes in their economies that will increase growth, produce sound balance-of-payments positions, and cut inflation. The countries are supposed to strengthen their private sectors and reduce budget deficits, put in supply-side programs such as tax reductions, liberalize trade, and promote foreign investment. Such policies, Baker says, will build confidence, encouraging domestic savings and stopping the flight of capital.

If the debtors buckle down to those prescribed changes, lenders open Fronts 2 and 3: commercial banks around the world grant the countries about \$20 billion of new loans over the next three years; and the so-called multilateral development banks—the World Bank, the Inter-American Development Bank, and others—supply another \$20 billion. Lending would continue case by case, with each country's loans negotiated separately.

Baker wants to see the World Bank play a major role in making good things happen. In recent years it has begun making what it calls "policy-based loans," which aim at Baker-like structural changes. For example, the Bank finances certain imports for countries willing to knock down trade barriers that would have kept those imports out. In almost all its loans it operates with carrot and stick, doling out money only as borrowers make headway. Baker wants the Bank to prod the 15 countries.

But behind the facade of this plan are endless complications that may scuttle it:

► Baker's structural changes add up to political dynamite and are impossible to put into effect quickly, if at all. The Reagan Administration has campaigned for such changes before and has got so little that Baker is making another pass at the well.

► Lining up the banks will be an organizational nightmare. For the plan even to get started, some 700 banks in 50 nations have to commit to lend \$20 billion, providing those structural changes get made. In percentage terms the money asked is not big, amounting to only 7.3% of the banks' outstanding loans to the 15 countries, or an annual increase of about 2.4%. The U.S. money center banks can see a compelling reason to put that up: the investment promises to keep interest payments on existing loans flowing in. Also, as Baker has said, the big banks "have an ox in the ditch." They are looking for any way to get that fellow out.

But U.S. regional banks have reason to balk. Many have written down their foreign loans by a lot or sold loans to eliminate their exposure to a given country. Suppose a regional has largely written down its Brazilian loans and is out of Argentina entirely. Is it now to get back into Argentina by joining in the \$20-billion commitment? Whoa. As a banker bitingly says, "This is not a new-business effort." Yet the cooperation of the regionals is essential to Baker's plan because the money center banks aren't ready to sign on by themselves. Were they to do that and be called on for new loans, part of the money would flow back to the regionals as interest on old loans.

► The World Bank is an imponderable: conservative, methodical, bureaucratic, a big borrower in the financial markets and therefore superprotective of its credit rating (AAA). In its 1985 fiscal year, a period of desperate need for many countries, it did not commit all the money it had expected to, partly because so few countries met its standards of creditworthiness.

In recent congressional hearings, Baker has conceded that his plan will be difficult to execute and uncertain in results. But, he says, "we do not see any alternative to an approach of this nature." In other words, count this as a last-ditch effort.

A Baker's Dozen Plus Two

For U.S. banks Latin America is the zone of pain. But Baker wanted support for his plan from foreign banks with problem loans concentrated elsewhere, so his list of troubled debtors has geographical spread. Variable interest rates apply to more than half the debt, which means the interest burden can swing sharply. Interest figures show what the countries owed in 1985—but some, such as Peru and Bolivia, didn't pay in full.

COUNTRY	FOREIGN DEBT in billions	1985 INTEREST		DEBT OWED TO U.S. BANKS in billions
		in billions	estimated % of 1985 GNP	
Brazil	\$103.5	\$11.8	5.8%	\$23.8
Mexico	\$97.7	\$10.0	6.3%	\$25.8
Argentina	\$50.8	\$5.1	7.9%	\$8.1
Venezuela	\$32.6	\$4.1	8.1%	\$10.6
Philippines	\$27.4	\$2.1	6.2%	\$5.5
Chile	\$21.9	\$2.1	12.9%	\$6.6
Yugoslavia	\$20.0	\$1.7	3.6%	\$2.4
Nigeria	\$18.0	\$1.8	1.9%	\$1.5
Morocco	\$14.4	\$1.0	8.2%	\$0.9
Peru	\$13.9	\$1.3	10.8%	\$2.1
Colombia	\$13.9	\$1.3	3.3%	\$2.6
Ecuador	\$7.9	\$0.7	6.0%	\$2.2
Ivory Coast	\$6.3	\$0.6	8.7%	\$0.5
Uruguay	\$4.9	\$0.5	9.8%	\$1.0
Bolivia	\$4.2	\$0.4	10.0%	\$0.2
TOTAL	\$437.4	\$44.5	Average 7.3%	\$93.8

surdity of the debt crisis: even while international banks lend capital to the debtor nations, their citizens spirit billions cross-border and into the banks' private banking departments (see following article).

The ultimate curse for the poor countries is that they are swept along by whatever worldwide economic ill winds happen to blow. Rising interest rates? They're poisonous. Recessions in the industrialized countries? That means reduced exports for the developing countries. Protectionism? It would strangle exports and is a dire threat of the moment. The rise of protectionism frames the core problem of trade surpluses: not all countries can run them at once.

The whole cobwebby mess has produced a lot of pessimists who hoot at the idea of "a temporary liquidity problem," solvable if we all just rope ourselves together and climb that mountain. Lately, moreover, some members of the team have suggested they'd just as soon not climb. In September at the United Nations two new presidents, José Sarney of Brazil and Alan García Pérez of Peru, gave speeches about the debt problem that rose above run-of-the-mill rhetoric. Sarney described his country and its neighbors as crushed by their foreign debt—\$103.5 billion in Brazil's case—and warned that policies aimed solely at generating trade surpluses to pay interest were intolerable. The sacrifices asked, he asserted, threatened Latin America's democracies.

García's speech got rapt attention because he has put himself on the leading edge of the debt problem. In July, with Peru already many months in arrears on its debt of \$13.9 billion, García announced formally that the debt would not be serviced as scheduled. Instead, he said, 10% of Peru's export income would henceforth be assigned to interest and repayments. This unusual approach to tithing looks as if it will this year produce about \$340 million for debt service, against a total interest bill of \$1.3 billion, not to mention billions more up for repayment. García sounds as if none of the \$340 million will go to the banks. Instead, priority is to be given to the World Bank and other official creditors. These lenders get preference because, unlike the banks, they have always insisted on honest-to-goodness repayments as a condition of extending further loans.

García's manifesto forced the U.S. Inter-Agency Country Exposure Review Committee, a body of banking supervisors that sets rules on how foreign loans should be valued, to declare most of Peru's loans "value-impaired." That classification requires the

banks to set up reserves against the affected Peruvian loans, as they have been required to do also for certain loans to Bolivia, Liberia, Nicaragua, Poland, Sudan, and Zaire. The committee ordained that the minimum reserve for Peru be 15% of the face value of the loans. No logic explains the 15%, and committee members won't explain. Certainly García has not sounded as if the loans were still 85% good, nor would banks be able to sell their Peruvian loans for anything like 85 cents on the dollar (though you can certainly bet they'd jump at the chance). The 15% is just the committee's way of rumbaing around this problem. Next year, if its past

The prospect is a queue of slow-pay, low-pay, no-pay countries serving as a constant reminder that the banks' loans are not worth their stated value on the books.

habits are a clue, the committee may decree another 15% or so, and on from there.

The Peruvian events illustrate a pervasive problem about cross-border borrowers: in the end they will pay only what they want to pay. Their opinions about how much is fair to pay may change as generations succeed generations and as political leaders come and go. In some cases, leaders will surely make political capital out of not paying.

Bankers have said in the past that the exports of recalcitrant borrowers will be seized and that their ability to import essentials, such as medicine, will largely disappear. No such blows seem at the moment to be falling on Peru, though perhaps the bankers are delaying retribution in hopes that García can be brought around to reasonableness. Meanwhile, Baker put Peru on his list of 15, as if to say, "Come home and all will be forgiven."

AS MANY schoolchildren learned, Finland kept paying its World War I debts to the U.S. after all other countries stopped. In Baker's list there may be a Finland or two. The surer prospect, however, is a queue of slow-pay, low-pay, no-pay countries serving as a constant reminder that the banks' loans are not worth their stated value on the books.

The main question for the banks is not

whether their loans will be written down, but how that will be accomplished. The banks seem to have a choice: keeping up the pressure on the debtors or becoming more conciliatory. If the banks keep bearing down, repudiations seem sure to cripple the loans—Peru-style repudiations, if no other. Alternatively, if the bankers were willing to drop the round-tripping charade, they could cap their losses and also begin to bargain with debtors, ratcheting down the debt to levels the countries can more likely handle. Concessional interest rates could have the same effect. Various public figures, such as Federal Reserve Vice Chairman Preston Martin and economist Allan Meltzer, have proposed that the banks exchange their debt for equity interests in Third World enterprises, such as utilities. Some of that could work.

A conciliatory approach of whatever kind might leave the banks salvaging more of their debt than they would by playing hardball. They could, for example, cut a deal that required some of the debtors to pay only half as much interest. Such a reduction would leave certain large debtors with debt-to-exports ratios of 2 to 1, which might be manageable. But banks still couldn't be sure that the debtors would honor the deal. Ultimately, they must always come back to their inability to force sovereign states to pay.

In all scenarios, the banks' interest revenues would drop and so would profits. Stockholders' equity would also sink. But these events, though sickening for managers and shareholders, would not in themselves threaten the banking system. A crisis would occur only if depositors interpreted these financial lurches as a reason to withdraw their money from the affected banks. The Fed, it would seem, could prevent that from happening by stating that deposits in all the affected banks are good, even those above the \$100,000 level guaranteed by the FDIC. The guarantee has been implicitly in place for large banks since Continental Illinois almost went under, at which point the FDIC assured all depositors they would suffer no loss.

The Fed could conceivably take still another plunge at this problem. To preserve the illusion that the banks are left with sufficient equity capital, the Fed might decree that the stricken loans be left on the books at a relatively high value, or perhaps be written down slowly, over many years. That solution would be unorthodox, but we are not talking here about a minor-league problem. We are considering the best way for the banking system to extricate itself from deep trouble that never should have developed. **F**